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ABSTRACT

In June 1978, California voters approved Proposition 13, limiting property taxes to 1 percent of a property's market value and limiting the property's growth in market value to 2 percent per year. The immediate effect of the limitations was to reduce property tax revenues by \$7 billion, of which \$3.1 billion would have gone to the schools. The California Legislature responded by allocating \$4.1 billion of the state's surplus to local governments, \$2 billion of it earmarked for school districts. This "bail-out" lowered the share of educational costs financed locally from 52 percent to 28 percent. Examination of future state revenue projections indicates that the state will continue to generate surpluses that can be used to replace lost property tax revenues and that, despite the 2 percent limitation, property reassessments will lead to higher property tax revenues than once anticipated, though the additional revenues will come primarily from owners of residential property. Other possible consequences of Proposition 13's passage are the equalization of property tax burdens across the state and growing state control over local expenditures. (Author/PGD)

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CALIFORNIA AND PROPOSITION 13:
A BRIEF ANALYSIS

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CALIFORNIA AND PROPOSITION 13

On June 6, 1978, California voters approved Proposition 13 by a 2 to 1 margin. Proposition 13 limited property tax collections to one percent of market value (plus funds to retire existing bond issues), and limited the growth in the assessed value of property to 2% per year unless a property was sold. This one percent limitation reduced property tax collections, the major source of revenue for all elementary and secondary schools, by 57%. Of the total \$7 billion reduction in property taxes, the schools lost \$3.1 billion. In addition, Proposition 13 does not allow school districts to ask voters to approve additional property taxes.

Proposition 13 became effective less than one month after its passage, giving the state, and local governments little time to revise their 1978-79 budgets. Less than two months after Proposition 13's passage, the Legislature passed major legislation to bail out those local governments which rely most heavily on the property tax. A total of \$4.1 billion was provided from state surplus funds for this purpose. Of this \$4.1 billion, \$2 billion was earmarked for school districts. Even with the bail-out funds, predicted revenue losses indicated hard times ahead for local government. Yet many of the dire predictions of Proposition 13's opponents have failed to materialize. Restrictions on government revenue are not as tight as originally estimated, and for a number of reasons, Proposition 13 only reduced the level of public services by 3% in its first year (1978-79). And, some estimates indicate that it may only reduce the growth rate of public services by about 1% in future years.

The Legislature's Bail-Out

Faced with a revenue loss of \$7 billion, local governments turned to Sacramento where they asked the State Legislature to share the state's large surplus with them. In just two months, the Legislature developed a plan to do exactly that. The Legislature appropriated \$4.1 billion in bail-out funds for local governments, and in addition made another \$900 million available in loans to local governments. At this point locals are not taking advantage of these loans since they will have to be paid back later, and the future revenue picture is still cloudy.

Of the \$4.1 billion bail-out, \$2 billion was provided for schools. The money was distributed through a formula which provided state aid to school districts based on a percentage of the estimated 1978-79 revenue that would have been generated if Proposition 13 had not passed. Revenue guaranteed from state aid, property tax collections and local reserves would not be less than 85% nor more than 91% of the 1978-79 pre-Proposition 13 level. Effectively, high spending districts took a 15% cut from their proposed spending level for 1978-79 and low spending districts took a 9% cut.¹ Overall, schools received funding equal to 98.6% of 1977-78 levels, or about 90% of planned 1978-79 budgets.

The bail-out also required a ten percent across the board cut in a number of categorical programs, including programs for the educationally disadvantaged, compensatory education, specialized reading programs, bilingual-bicultural education and several other programs.

The bail-out legislation also required that school district employees receive no cost of living increases in 1978-79. Thus district workers, as well as other government employees, bore part of Proposition 13's

burden. But perhaps the most noticeable impact of the bail-out legislation is the fact that it lowers the share of educational costs financed locally from 52% to 28%.²

Proposition 13's Future Impact

In the aggregate, local governments in California fared quite well during the first year of Proposition 13. Many of the dire predictions of service cuts and massive layoffs did not materialize. This is due in large part to the state's \$4.1 billion bail-out. In addition, actual property tax collections in Fiscal Year 1978-79 were \$405 million higher than anticipated. Further, local non-property tax revenues grew by a total of \$1.716 billion in 1978-79. When these factors are combined with the fact that employee salaries were not allowed to grow in 1978-79, actual revenue available to local governments was only \$173 million less than was available to them in 1977-78. If one projects an 8% rate of inflation, non-salary expenditures would have to increase by 8% over 1977-78 levels to maintain 1977-78 service levels. (Salary costs were required to be held at 1977-78 levels). Using the factors mentioned above, the revenue shortfall to maintain service levels in 1978-79 amounts to \$857 million or 2.8% of the necessary level.³

Of course, local government's ability to maintain this revenue level in the future rests on a number of assumptions. First of all, the state must continue to have a large surplus and be willing to share it with local governments. Secondly, property tax revenues must grow at a rate greater than the 2% limit on growth of assessed value. This assumption appears to be realistic as the discussion below will show.

Looking at future state revenue projections, it appears that unless the Legislature enacts a tax cut, or allows state spending to grow at a rate significantly greater than the rate of growth in personal income, California will be able to generate considerable surpluses in the future. The state tax structure is considerably revenue elastic. This means that a one percent increase in personal income will result in an increase in state tax collections of more than one percent. Recent estimates of the state's revenue elasticity indicate that a one percent increase in personal income translates to a 1.7% increase in revenue. If inflation rates hover in the 7 to 8% range, the state will experience a 5% real increase in revenue each year.⁴

Since it is unlikely that the Legislature will attempt to increase state expenditures at rapid rates in the near future, the state appears able to generate considerable surpluses in the future to continue the bail-out program.

Even if the state continues to generate and share a surplus with local governments, the 2% limitation of the growth of assessed valuation appears to impose very strict limits on local governments. Yet there is evidence that this limit is not as tight as originally envisioned. Property tax collections were \$405 million higher in 1978-79 than anticipated. This was due largely to the fact that assessors were allowed to bring all property up to 1975-76 levels. Although California law requires a periodic reassessment every three years, there were a few areas where property had not been brought up to those levels. In addition, assessors are allowed to revalue property at its market value

when it is sold. Consequently, all property that was sold between 1975-76 and the passage of Proposition 13, but which had not been reappraised because of the periodic assessment policy, was revalued upward to its market value on the date it was sold. Because of the rapidly skyrocketing property values in many parts of the state, some homeowners found themselves with large increases in assessed value, and in some instances, higher property taxes.

It appears that because of the rapid turnover in residential property, the assessed value of all residential property in the state will continue to grow at almost the current rate. Residential property turns over an average of once every seven years in California. If one assumes an actual increase in the value of residential property of 10% a year (a modest assumption), its value will double in seven years. Whether the assessed value of an average house is increased by 10% a year, or is doubled every seven years when it is sold, the result over time will be the same.⁵

With the assumptions discussed above, it appears that residential property values will increase at 9% a year. (If housing values increase at 10% a year, the value of housing stock in place in 1978-79 will grow by 9% in 1979-80.) In addition, we must add new construction, which amounts to 2% to 4% a year. This means the residential property tax base will grow by 11% to 13% a year, not much below its current rate.

Non-residential property does not change hands as frequently, so its growth rate will closely approximate the 2% annual limit. In addition, new construction accounts for about 2% a year, making the growth in the non-residential property tax base about 4% a year. The combined residential and non-residential growth rate then would be approximately

8% a year.⁶ This is only two percentage points below what would have been expected without Proposition 13. But with the state's increased aid to local governments, this loss of revenue will not be as significant as if the state had not assumed a larger share of the costs of local government.

In summary, it appears that local governments can sustain a rate of growth of almost 10% a year in the foreseeable future if the state continues to help with surplus funds and residential property continues to increase in value at the same rate and is traded with the same frequency.

Other Consequences of Proposition 13

Two consequences that stand out from the preceding analysis are the large increase in the percentage of local revenue provided by the state and the apparent shift of property tax burdens to residential property. A third consequence of Proposition 13 is the equalization of property tax burdens through the state, since property taxes are now limited to 1% of market value.

The large share of local revenues provided by the state brings with it a number of critical issues regarding local control. Political theory in general indicates that the control of public expenditures ultimately rests with the body responsible for raising the revenue. Recent examples of this loss of local control in California are the prohibition against employee cost-of-living increases, and against reductions in expenditures for public safety (police and fire). Local control could become a thing of the past in California if such state policies continue.

Proposition 13 appears to shift reliance on tax revenues from the property tax to the state's income tax, a far more progressive tax. However, the 2% limit on growth of assessed value unless a property is sold will have the effect of shifting the property tax burden to residential property and away from business and commercial property.

Finally, the state bail-out legislation appropriates the property tax collections to the counties on the basis of their proportion of the total assessed valuation of the state, and then requires the county to distribute those revenues to taxing districts in proportion to their pre-Proposition 13 share of total property tax collections. The result of this will be the sharing of property tax bases in the future, eliminating inequities between low and high wealth areas.

FOOTNOTES

1. "Proposition 13 and the Schools." Tax Revolt Digest, Special Report Number 1, December 1978, page 1.
2. Oakland, William H. "Proposition 13 - Genesis and Consequences," Federal Reserve Bank of San Francisco Business Review, Winter 1979, page 19.
3. Ibid. page 14
4. Ibid. page 12
5. Ibid. page 17
6. Ibid. page 17